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TESTIMONY OF

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SUPPLY CHAIN INTEGRATION

BEFORE

SUBCOMMITTEE ON NATIONAL SECURITY, EMERGING THREATS, AND

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OF THE

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Overview of the Department of Defense

Excess Property Systems

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Chairman Shays, Congressman Kucinich, and Members of the Committee:

Thank you for the opportunity to appear before you and discuss the Department's Excess Property Systems. I am Alan Estevez, Assistant Deputy Under Secretary of Defense for Supply Chain Integration. In my position, I am responsible for developing Supply Chain Materiel Management Policy in the Department of Defense (DoD), which includes policy on reutilization of excess assets. The Defense Reutilization and Marketing Service (DRMS), a part of the Defense Logistics Agency (DLA), and the Military Services are charged with implementing and executing our policy.

I appreciate the opportunity to provide our views of the Government Accountability Office (GAO) draft report, *DoD Excess Property: Management Control Breakdowns Result in Substantial Waste and Inefficiency*. I will discuss the solutions we are implementing to improve the Return supply chain as it applies to reutilization and disposal.

Before we do that, I wish to commend the GAO audit team for the positive recommendations contained in the report. I appreciate any assistance that helps us improve support to our forces. I also appreciate the opportunity to tell you what the Department has done and what the Department is doing to improve our processes. We

are actively engaged in making the recommendations reality and are working to improve how we buy, position, and manage inventory, ensuring our warfighters have what they need to fight and win the global war on terrorism.

While this particular report focuses primarily on the Return portion of the supply chain, it is only a small, but significant portion, of the Department's logistics mission. All supply chains have three primary ingredients: people, processes, and technology. Ideally, we want all three aspects of this supply chain to be in perfect balance. During the course of my testimony, I will discuss what we are doing to address all three of these enablers as they relate to disposal and reutilization. The return supply chain is truly dependent on the integration of these three factors.

While the Return supply chain is the subject of this hearing, the return process is only a part of the three supply chains that operate in DoD; the return process must be examined in the context of these DoD supply chain processes. The first supply process supports complex weapons systems, the second is for commercially available materiel such as petroleum, food, construction materiel and medical supplies, and the third supply chain supports our deployed troops in hostile and dangerous environments. Each of these supply chains has its own challenges in terms of the reutilization and disposal process.

The bulk of the Department's energies are focused on the front end of the supply chain where it has the greatest impact in supporting our forces, that is, *getting the warfighter what he or she needs before they ask for an item*. That is and must be my primary focus.

Policy Guidance is Sound

However, we do not take lightly our responsibility to monitor the Return process and make long lasting improvements. To that end, we need to implement the recommendations as outlined in the GAO Audit Report. The report pointed out that over $2.2 billion of items in 'A' condition was reported to disposal as excess for FY 2002 and FY 2003. While that seems like a lot, our results actually represents 1.65% of our average inventory value in FY 2002 and 2003, which is comparable to industry figures. In most large companies, inventory reserves range between 2 and 4 % depending on industry, and we do well in comparison considering our challenges. However, our primary focus should not be on how much we made on the re-sale of these items; the important point is getting the right items to the warfighters when they need them, while simultaneously providing optimal return on the investment of the American public.

While there is room for improvement, we are confident that our published policies regarding DRMS across the Department are sound. DoD policy states that material available in the disposition system will be used to the extent feasible, to prevent buying and disposing of the same materiel simultaneously. At the same time, under Title X authority (organize, train, and equip), the Services as well as DLA are responsible to ensure that they are following those regulations, instructions, and manuals as they go about their daily work.

Inventory Management at DoD

I think it would be useful if we spent some time discussing how we see the inventory management side of the business. DoD Logistics activities do a good job of

getting things to where they need to be given the challenges of our operational environment, and we are making significant improvements in that area. The logistical support of operational readiness for the war fighter is complex. Inventory levels for more than 5 million parts are set to maximize readiness within budget constraints.

The Services and DLA have made substantial investments of human resources in systems designed to determine the allowances and stocking levels required to support a given operational baseline. Our inventory levels reflect the recommendations of these systems and models as to the appropriate quantity of inventory required to support war fighter readiness and weapons system availability, given our current business practices. Purposefully, our models drive us to hold levels of materiel in support of a high level of readiness, which we optimize by appropriate use of safety stock and buffers. The assumptions in most models are conservative, resulting in higher levels of safety stock for key weapons systems than a commercial enterprise might accept. We are striving to improve our business practices that support weapons systems readiness and, of course, we will update our models accordingly.

Our approach to safety stock reflects the difference between the cost of a stock out in a commercial enterprise, and the cost of a back order for the military. A stock out in the commercial world results in the lost of profit from a foregone sale, and potential customer dissatisfaction. A stock out on a weapons system means a plane not available for mission support. Thus, the calculus for setting inventory levels drives us to set higher safety stock levels.

As previously noted, we face challenges in setting inventory levels not normally experienced in industry. For example, we hold $7.4 billion in secondary item war reserve materiel, particularly for items which have significantly higher usage in contingencies and wartime. If that scenario does not materialize, and their usefulness passes, they would be turned into the reutilization process. In addition, some of these items such as medical items have limited shelf life, while others are rendered obsolete by technical progress. All of these factors contribute to our obsolescence and scrap rates, and drive lower recovery rates from the sale of DoD excess materiel than in the commercial world.

We also operate in a challenging and diverse environment with the three major supply chains as previously described. We support a range of weapons platforms, some of which have been in operation for many years. For example, the B-52 made its first flight in 1952, and is still flying. Many of the parts for these platforms are no longer made, and we have made end of life cycle buys to ensure operational availability of the weapons platform. When a technological upgrade is made to the platform, these parts may be rendered obsolete and would then be transferred to DRMS.

On the other end of the spectrum, we want to ensure that our soldiers, sailors, airman and marines have the best technology available in areas of great technological advances, including avionics, communications, and medical equipment. In such areas as personal armor, radio communications, medical devices, and battlefield C^3I, technology advances they have rendered previous devices obsolete and of little market value. On that same B-52, designed over 50 years ago, we are using state of the art electronics capable of delivering ordinance on target in ways that were unimaginable when the

airframe was developed. Therefore, to fulfill our mission we need to provide parts that are both very old and state of the art. We need to manage inventory to meet both needs.

Comparison to Industry

Any organization that uses inventory to meet demand will have write-offs and obsolete inventory. The Department's write-offs of $1.05 billion per year is 1.65 % of total inventory averaged at year end ($63 billion is 2002, $67 billion in 2003). It is difficult to compare the DoD experience to any one commercial industry, because we are a combination of industries; high tech, aerospace, automotive and many other supply commodities. The comparison is even harder to make because we value our inventory at latest acquisition cost, not its market value. If we normalized our write-off percentages to commercial standards, our excess and obsolete percentages would be even lower.
Let me give you a couple of examples from our commercial counterparts. The average car dealer's parts inventory will have 20% defined as excess (more than one year's usage), and 20% as slow moving (more than six months supply). As you read the financial news, you'll see companies announcing large write-downs in inventory value. The most striking was Cisco, the widely admired provider of networking equipment, which wrote off $2.25 billion of inventory, or 20% of their cost of sales for the year in 2001.

The report also points out that DRMS was unable to account for $466 million of inventory over three years. Compared to $31 billion turned over to DRMS over the two year audit period, this is 1.0% of the total volume handled. While there are differences in our business models, a variety of retail industries, including clothing, convenience and

electronics stores, will show that "shrink," as this type of loss is called, averages between 1.7% and 1.9% per year. However, we are focused on making our results much better.

How are we Doing?

Our performance in supporting the warfighter's requirements is good, but will always need improvement. Operational availability and fill rates, two indicators of the performance of the Department's supply chain, are high and improving while operating costs are decreasing.

1. Supporting deployed weapons systems quickly and effectively. We are achieving 30 to 40 percent increases in materiel availability, a 70 to 80 percent reduction in lead times, and historically high readiness levels for systems deployed in Iraq today. Part of this improvement is due to our Performance Based Logistics (PBL) strategy, in which we work with suppliers of key systems to buy performance, not piece parts. We have over 100 PBL contracts in place currently, and the impact on cost and operational availability for such platforms as the F/A-18 has been significant.

2. Increasing materiel availability. For those items which the Department manages, across the three key supply chains we discussed, we have expanded our level of responsiveness. Today, materiel availability for the Defense Logistics Agency is 88 percent (versus a target of 85 percent) and backorders hit a historic low in March 2004.

3. Cutting costs. Through aggressive partnering with industry, DLA's cost recovery rate -- the cost of the services DLA provides to military services as a percentage of DLA sales -- is at a historic low of 15 percent this year.

4. Decreasing inventory. Our inventory has decreased from a high of over $100 billion in the 1990's, to slightly over $70 billion today with increased operations.

There are numerous factors that affect these metrics, but, the bottom line is, we are improving all aspects of our inventory management process.

What are we Doing to Improve?

However, there is still more to do. The best approach to any problem is to prevent it before it occurs. In the case of disposal, the greatest opportunity lies in re-examining how we bring assets into the inventory, and in lowering the amount of this materiel purchased and maintained in the supply pipeline without impacting readiness. To that end, we have several programs underway to improve support levels to the warfighter that will reduce obsolete and excess inventory as well:

Readiness Based Sparing (RBS) is a methodology to enhance equipment readiness by applying advance mathematical modeling techniques to setting inventory levels. This initiative will leverage the work the Services and DLA have already done in RBS by using newer technology and off the shelf software. Organizations which have implemented RBS have seen an increase in service levels as similar or lower levels of investment in inventory, and we expect similar results across the Department.

Commodity Management is a strategy to address long lead times, and uncertainty of supply drive higher inventory safety stock. There are several commodity teams across the Services currently, doing excellent work in rationalizing our procurement and supply chain management in areas critical to the warfighter such as jet engines, Auxiliary Power Units, and other key commodities. DoD has also established teams to look at our purchase of services such as telecommunications and temporary help at the Department level. Since our true leverage across the Department comes from looking at our spending as a whole, DoD has two cross-Service commodity teams currently underway, tasked with understanding the entire Department's usage patterns and requirements, and the capabilities of the supply base in that commodity. Based on the findings from these initial Department level teams, we will determine how to best implement commodity management across the Department. A comprehensive commodity management approach will allow us, among other benefits, to identify strategies to diminish lead times and deal with suppliers with a proven track record for delivery and quality, thus decreasing requirements for safety stock.

Continuous improvement. The Departments is actively engaged in Lean/Six Sigma programs to drive process improvement, and have already seen the results in NAVAIR, the F-15 program and other platforms. Lean will lead to lower inventories, and processes which are more capable. As a result, we will see shorter cycle times, and less buffer stock to cover demand uncertainty over the purchase lead time.

Improved asset visibility. There are currently has significant efforts across the Department to upgrade and integrate logistics systems. This will lead to the ability to integrate purchasing systems and reutilization systems Department-wide. Integrated systems, built on modern technology, will make it easier to give item managers visibility into DRMS Automated Information System (DAISY) and other reutilization systems, allowing them to check for available excess parts before placing new orders. Likewise, RFID implementation will also help manage our inventory.

As representatives of DLA will describe in their testimony, DLA will modernize the disposal information process over the next few years, incorporating it into their Enterprise Resource Planning system.

We will continue to prioritize our efforts towards improving readiness. The primary mission of our logistics enterprise is to ensure the warfighter has the materiel to fight and win wars, and all of our programs and initiatives have this as a primary objective.

We Can Still do Better

Major General Mongeon will address many of the specifics of what DRMS is doing to increase its effectiveness. However, I will focus on some of the actions which we believe can lead to better results in our reutilization supply chain. These are:

1. I have asked the Military Services and the Defense Logistics Agency to evaluate their training materials and practices so we can better assess the root causes of the various documentation errors addressed by GAO. The Services and DLA are in

the early process of the assessment and will respond with any and all actions taken or planned. Once completed, I will ask the DoD Inspector General to follow-up and let me know how the military Services and DLA are progressing. Upon review of their assessments and the results of an IG look, we will re-evaluate our policies.

2. We are also investigating whether to create a new condition code that will allow us to track condition code "A" items (serviceable items that are new, used, repaired, or reconditioned materiel) that are obsolete. However, we need to be careful in assigning that designation, because if we mark something obsolete none of the Service customers are likely to accept the item for reutilization. The audit team found a number of condition code "A" items that although useable, were identified as obsolete for the application. As stated previously, it is not unusual for DoD to end up with a number of "new and unused parts" still in inventory, when an engineering change order or upgrade requires the installation of a new part in an aircraft or tank to correct some design problem or to make an improvement in performance.

3. We will review the current process and procedures for turn-ins to determine if there are opportunities for tighter controls and capture of information at point of return which will enable DRMS to better categorize its inventory for potential reutilization.

4. Additionally, the GAO report cited that the Department purchased at least $400 million of identical items during FY 2002 and 2003 and it reported we should have

used available excess items in A condition. Assets in DRMS will be reviewed by inventory managers to ensure DRMS does not have like items in stock. DLA plans to ensure visibility of excess inventory across the Department by linking the Reutilization Management System (RMS) to the modernized component logistics systems, as part of the DoD logistics systems modernization effort. Since January 2000, DoD has focused on the modernization of information systems to support modern supply chain practices and to improve department-wide financial accountability. The task remains challenging both in integrating all logistics information into logistics processes within each of the Military Services and the Defense Logistics Agency and linking these systems across Services.

Conclusion

In conclusion, my primary objective is to support the warfighters, while carefully considering the interest of the taxpayers. Having said that, our focus from a policy perspective is on our two customers. Our first focus in on the soldiers, sailors, airmen, and marines, who are out on the front line defending our country. We need to get them the best equipment and supplies that permit them to get their job done in the safest way possible. And second the taxpayer, who is paying the bill for the defense of the nation. Efficient and effective reutilization is a key component in serving both groups, and I've outlined how we plan to improve our reutilization and disposal practices by implementing the GAO's recommendations, and by continuing the initiatives we already underway to improve our end to end supply chain.

The DoD logistics enterprise is a $129 billion business. Our investment in inventory exceeds $70 billion. We will continue to look for opportunities to optimize our resources and improve operational availability. We will focus on implementing initiatives to achieve greatest return in improving cost-effective support to the warfighter, and continue to evaluate our processes to ensure that our men and women in harm's way have what they need when they need it to fight and win wars.

In closing Mr. Chairman, thank you for the opportunity to testify before the Committee about our Excess Property Systems. I would be happy to answer any questions you and the Members of the Committee may have.